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The Sum of All Investments

A rigorous annual portfolio evaluation identifies sources of value creation and destruction.

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A company is many things. It is a gathering of people collaborating on various activities necessary to operate the business enterprise. A company can also be viewed as the range of products or services it delivers, or even as a collection of stores, manufacturing plants, research-and-development laboratories, salespeople, hotels, airplanes, gas stations, engineers, or cruise ships.

Regardless of what industry the company competes in, for strategic planning and business-management purposes, it is imperative for CFOs and other senior executives to consider the company as the sum of all investments. This provides science and structure to new investment decisions to beneficially shape the future of the company.

Every investment has a current value that can be compared with the capital invested. For example, a successful capital investment of $100 million to buy a successful cruise ship might now be worth $130 million, creating $30 million of new value.

ANALYSIS

Some investments add more value than they cost, as in the previous example, and are considered value creating. Some others add just as much value as they cost and are value neutral, while others add less and are value destroying.

That analysis helps management to deliberately make more investments that create value and fewer investments that destroy value. This may seem obvious, but many companies don't do it, either because executives believe they know the answers or because they never placed a high-enough priority on gathering the required information. Companies should regularly and systematically analyze the value-creation contribution of all existing and contemplated investments in their portfolio to ensure their forward plans are properly directed.

A How-To Guide to Portfolio Evaluation

The first step is to identify the business assets to be analyzed. For a retailer, it may be best to analyze each store, region of stores, or merchandizing category. An electric-power-generating company may analyze each power plant. A car manufacturer might evaluate each car model and each manufacturing plant. For a multibusiness conglomerate, the best view may first be by business. In that case, the nature of the analysis will be different within each business, depending on the business model.

The data can be sliced in different ways and it is often best to analyze a few different cuts, since each can provide special insights that inform different types of important decisions.

Let's consider a real-world example to help illustrate this analytical approach. During fiscal year 2012, Carnival Corp., a cruise and vacation company, had revenue of $15.4 billion. The vast majority of this was generated by its 100+ cruise ships and what the company labels "cruise support." At a minimum, management should understand value creation ship by ship.

Once we settle on the assets or business elements that will be analyzed, we must select a methodology to determine which investments create value and which destroy value. For Carnival, we must value each ship and compare each value to the amount of capital invested.

Once we analyze the value creation and/or destruction of each ship, we relate these findings to ship characteristics to determine which types of ships are more likely to create value. Do the large ships create more value, or do the small ones? Which cruise line brands are best? Are the better-appointed ships more successful or do the bare-bones economy models produce better value? Does the location of the cruise affect value creation? Since relating value creation or destruction to ship characteristics in this example is the most useful part of the analysis, it is helpful to analyze a wide range of ship features to determine the really important drivers of success.

The final step is to determine which strategic actions to take. The assets that create the most value should be strongly emphasized in new investment plans to energize profitable growth. For example, if large deluxe ships create the most value, then all or most new shipyard orders should be for large deluxe ships.

Those destroying value should be fixed, sold, or shut down. And no more capital should be invested in such assets until management proves it can “earn the right to grow” in these areas. Perhaps management can save fuel costs by emphasizing itineraries with more time in port and less under sail. Maybe some ships should be relocated from one region or continent to another where demand will be more favorable.

Try to spot cases in which current performance may misrepresent the true future potential. Returns may be high or low now, but the future might be more or less bright. Developing action plans also requires a careful consideration of competitor strategies and responses.

Go beyond the operating strategies of existing assets and tackle the investment plans going forward. High share prices result not just from performance on existing operations but also from expected performance on potential investments. This “value of the future” is highest when investors trust management is steering new investments toward areas where there is a strong track record and a positive outlook.

In fairness, some businesses are hard to analyze in this manner because of network economics. For instance, telecommunications networks are hard to analyze by asset, since each asset is only important and valuable when it is connected to all other assets. In network businesses, analyses by customer or customer type can provide more useful insights.

A properly structured portfolio evaluation should be executed annually at the start of the planning process as a means of identifying “where we are” as a platform for considering “where we should be going.” Until you have completed this critical strategic process a few times, you cannot be sure your capital-allocation decisions are really driving the best value-creation outcomes.

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